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No. 03-776

Supreme Court, U.S.
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In The
Supreme Court of the United States

FRANCHISE TAX BOARD,

Petitioner,

v.

FARMER BROS. CO.,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The Second Appellate District

REPLY BRIEF

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INTRODUCTION

Respondent raises two new questions in its Statement of the Case and relies on a case, *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal.App.4th 875 (2000), not discussed in the Petition. Petitioner, pursuant to Rule 15.6, files this reply to address those two questions and discuss that case.

ARGUMENT

A. The Doctrine of Internal Consistency Does Not Support a Finding That Section 24402 Unconstitutionally Discriminates.

The California Court of Appeal in a single paragraph (Pet. App. 14-15), and without discussion or analysis, summarily rejected the Franchise Tax Board's ("FTB") argument that section 24402 did not violate the internal consistency doctrine. Because the compensatory tax defense saves a facially discriminatory tax, FTB chose not to address internal consistency doctrine in its petition. Respondent now having raised the issue, Petitioner will reply.

1. The Doctrine of Internal Consistency as a Tool for Analyzing Discrimination

The internal consistency test was formulated in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983), as a means of determining whether an

apportionment formula is fair.[1] The Court stated, "[An] obvious component of fairness is what might be called internal consistency – that is the formula must be such that if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed." *Id.* at 169. The Court's discussion in *Container* related internal consistency only to the question of fair apportionment.

In *Armco Inc. v. Hardesty,* 467 U.S. 638 (1984), the Court, in analyzing a West Virginia tax scheme that integrated taxes imposed on manufacturing and wholesaling by allowing a credit against the wholesaling tax for the manufacturing tax, extended the use of internal consistency to determine if the scheme was facially discriminatory. The Court acknowledged that internal consistency was a standard for fair apportionment, but went on to say, "A similar rule applies where the allegation is that a tax on its face discriminates against interstate commerce. A tax that unfairly apportions income from other States is a form of discrimination against interstate commerce." *Id.* at 644.

The use of the internal consistency doctrine as a test of discrimination in *Armco* has been criticized by commentators. See, e.g., C. James Judson & Susan G. Duffy, An Opportunity Missed: *Armco, Inc. v. Hardesty*, A Retreat from Economic Reality in Analysis of State Taxes, 87 W. Va. L. Rev. 723 (1985); R.G. Lathrop, *Armco–A Narrow and Puzzling Test for Discriminatory State Taxes Under*

[1] Fair apportionment is one of the four prongs of the *Complete Auto* test, *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977), used to determine whether a state tax is permissible under dormant commerce clause analysis. Discrimination is a separate, distinct prong.

the Commerce Clause, 63 Taxes 551 (Aug. 1985). Its use as a test of discrimination has been questioned by members of the Court, *Armco, id.* at 648 (Rehnquist, J., dissenting), *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 at 257 (1987) (Scalia, J., concurring in part and dissenting in part), *Am. Trucking Ass'ns., Inc. v. Scheiner*, 483 U.S. 266 at 303 (1987) (O'Connor, J., dissenting). The court in a *per curiam* opinion, *Ashland Oil, Inc. v. Carly*, 497 U.S. 916 (1990), indicated that its application may be limited to facial discrimination cases, *id.* at 919, and suggested that its use might be limited to confirming that a facially discriminatory tax is not actually discriminatory if it meets the requirements of internal consistency, *id.* at 920, quoting Justice O'Connor's dissent in *Am. Trucking, supra.* Understood as such, internal consistency is either only an alternative to the compensatory tax defense to show that a facially discriminatory tax is not unconstitutional, or a device to confirm that a tax that is facially discriminatory is in fact unconstitutionally discriminatory. It has never, however, been used by the Court to trump the compensatory tax defense.

Members of the Court have expressed concerns about the use of the internal consistency doctrine as a test of discrimination, and the Court has not addressed the interrelationship of the internal consistency doctrine and the compensatory tax defense. Consideration of these matters provides an additional reason for the Court to grant review in this matter.

2. The Doctrine of Internal Consistency Is Not Applicable to the Taxation of Dividends.

Internal consistency addresses the question of apportionment. It is used to determine whether there is multiple taxation of the same income or event in the hands of the same taxpayer. Multiple taxation of dividends, once in the hands of the company earning the income from which the dividends are paid, and again in the hands of the recipient of the dividends, is constitutionally permissible. E.g., *Mobil Oil Corp. v. Vermont,* 445 U.S. 425 (1980). Therefore, under this Court's decisions, the doctrine of internal consistency has no application to the taxation of dividends vis-à-vis the taxation of the dividend payor and the dividend recipient.[2]

3. The Doctrine of Internal Consistency Is Not Violated in This Case in Any Event.

Internal consistency addresses the question of apportionment. As such, it is the apportioning process involved in the dividend deduction that must be scrutinized. The method used by California to determine the deductible amount of dividends is based upon an apportionment methodology that has been approved by the United States

[2] Internal consistency does have application in considering how the recipient of the dividend is taxed on its income. A State could not, for example, tax dividend income arising from a unitary business on an unapportioned basis if received by a domiciliary and an apportioned basis if received by a nondomiciliary. If every State followed that rule, more than 100 percent of the amount of the dividend would be taxed by the States, and the requirement of internal consistency would be violated.

Supreme Court, *Container Corp. of Am., supra*. An example demonstrates that internal consistency is satisfied.

> Example: Parent corporation P is taxable in California and State A. It receives dividends from corporation S, which earns 75% of its income in California and 25% of its income in State A. The dividend is included in the apportionable income of P. Under internal consistency, it must be assumed that both California and State A have section 24402. As such, all dividends are included in income, and a deduction is allowed by each state to the extent the dividends are paid from income earned in that state. S pays a dividend of $100 to corporation P paid from its activities in California and State A. The following would occur under section 24402.

	California	State A	Total
Divided Income	$100	$100	$100[3]
24402 Deduction	$ 75	$ 25	$100
Amount in Income	$ 25	$ 75	$100

> Varying the percentages would not vary the result.

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[3] Each state is considering the same dividend, but this does not mean $200 is being taxed. P itself would apportion the dividend income along with its other income. This step is not included in the example for the sake of simplicity since it is the pre-apportioned income that is included in the base.

B. The Preclusion of the FTB From Presenting Evidence on the Factual Predicates of the Compensatory Defense Does Not Present Constitutional Issues.

FTB, in its Petition, stated that it proffered a witness list of two professors who would testify to the presence of the factual predicates of the compensatory tax defense (Pet., p. 4), that the trial court denied the Taxpayer's Motion In Limine to exclude this testimony as moot, *id.*, filed an application for an extraordinary writ with the Court of Appeal for review of the trial court ruling on this ruling, *id.*, and that the application was denied, *id.* at 5. Evidence of the factual predicates of the compensatory tax defense is not present in this case because FTB was precluded from presenting such evidence. In any event, this procedural issue is not pertinent to, and does not impact, the necessity for the Court to grant review.

C. The Decision in *Ceridian* Is Distinguishable From the Instant Case.

Respondent cites to the California Court of Appeal's decision in *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal.App.4th 875 (2000), as a judicial authority dealing with a dividends-received deduction that is consistent with the California Court of Appeal's decision in this case. Petitioner did not discuss this case in its Petition because it has no application in the circumstances of this case.

Ceridian involved a California statute, Rev. & Tax. Code section 24410 (reproduced in relevant part in App. B to Resp. Opp., pp. 20-21, n2), that granted a dividends-received deduction to corporations commercially domiciled

in California for dividends received from an eighty-percent-or-more-owned insurance company that was paid from income arising from California sources.

The deduction in *Ceridian* suffered from a constitutional defect that is not present in this case, or in any of the other cases discussed by Respondent. The deduction was only available to corporations commercially domiciled in California. That is a facial discrimination for which the compensatory tax defense would never be an answer.

The *Ceridian* statute allows a dividends-received deduction rather than a proportionate reduction in the value of the intangibles being taxed. Therefore, disregarding the commercially domiciled defect, the statute in *Ceridian* is more similar to the statute at issue in this case than it is to the statute that was involved in *Fulton Corp. v. Faulkner,* 516 U.S. 325 (1996). But the facial similarity ends there. The deduction in *Ceridian* suffers from a second constitutional defect, the same defect as the tax in *Fulton.* In *Ceridian,* as in *Fulton,* there were two different taxes involved, measured by different bases, and assessed at different rates. FTB recognized that the Court's decision and analysis in *Fulton* was dispositive in the circumstances of *Ceridian* and, as a consequence, did not attempt a compensatory justification.

In contrast, the intrastate tax burden that section 24402 seeks to compensate for involves the same tax, imposed at the same rate, as the deduction provided to the dividend recipient by section 24402. Thus, while equivalence is not required to support a compensatory tax defense, the tax relief provided by section 24402, unlike that

in *Fulton* and *Ceridian*, is intended to, and does, provide relief that is comparable to the burden imposed.

CONCLUSION

Respondent's opposition to the granting of review may have facial appeal. Proper application of the compensatory tax defense, however, exposes the lack of substance to respondent's opposition just as the defense validates taxes that are only facially discriminatory.

Respectfully submitted,

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